

# Money and Banking

Chapter 31 explains how the financial system affects the operation of the economy. The chapter is largely descriptive and factual. Pay particular attention to the following: (1) what the money supply is and the function money performs; (2) what gives value to or "backs" money in the United States; and (3) the principal institutions of the U.S. financial system and their functions.

Several points are worth repeating. First, money is whatever performs the three functions of money (**medium of exchange, unit of account, store of value**). People are willing to accept and trust the use of money for transactions because people are willing to exchange goods and services for it. So money is backed by trust or acceptability *and not by gold*. Money also helps people measure the value of goods and services they want to buy or sell. In addition, money stores value for people so they can use it in the future to make purchases.

Second, the central bank in the United States consists of the 12 **Federal Reserve Banks** and the **Board of Governors** of the **Federal Reserve System** which oversees their operation. These banks, while privately owned by the commercial banks, are operated more or less as public agencies of the Federal government. They operate on a not-for-profit basis but are used primarily to regulate the nation's money supply in the best interests of the economy as a whole, and secondarily, to perform other services for the banks, the government, and the economy. They are able to perform their primary function because they are bankers' banks in which depository institutions (commercial banks and the thrifts) can deposit and borrow money. They do not deal directly with the public.

Third, these depository institutions accept deposits and make loans, but they also are able to create money by lending checkable deposits. Because they are able to do this, they have a strong influence on the size of the money supply and the purchasing power of money. The Federal Reserve Banks exist primarily to regulate the money supply and its value by influencing and controlling the amount of money depository institutions create.

The final section of Chapter 31 discusses recent developments in money and banking. First, there has been a significant shift in financial assets from banks and thrifts to other types of financial services institutions. Second, many banks and thrifts have merged over the years to better compete with other regional or national firms. Third, there has been a convergence in the services provided by the different types of financial institutions. Fourth, financial markets are now global and more highly integrated

than in previous decades. Fifth, technological advances have introduced electronic payments and changed the character of money.

## ■ CHECKLIST

When you have studied this chapter you should be able to

- ☐ List and explain the three functions of money.
- ☐ Describe the liquidity of an asset and give examples of it.
- ☐ Give an **M1** definition of money.
- ☐ Describe the characteristics of the currency component of **M1**.
- ☐ Explain the role of checkable deposits as a component of **M1**.
- ☐ Describe the two major types of institutions offering checkable deposits.
- ☐ Offer two qualifications about what is excluded from the money supply.
- ☐ Give an **M2** definition of money and describe its components.
- ☐ Distinguish between credit cards and money.
- ☐ Explain why money is debt in the U.S. economy and who holds that debt.
- ☐ State three reasons that currency and checkable deposits are money and have value.
- ☐ Use an equation to explain the relationship between the purchasing power of money and the price level.
- ☐ Discuss how inflation affects the acceptability of money.
- ☐ Explain what role government plays in maintaining or stabilizing the purchasing power of money.
- ☐ Describe the framework of the Federal Reserve.
- ☐ Explain the historical background of the Federal Reserve.
- ☐ Describe the purposes of the Board of Governors of the Federal Reserve.
- ☐ Explain why the Federal Reserve Banks are central, quasi-public, and bankers' banks.
- ☐ Discuss the functions of the FOMC of the Federal Reserve.
- ☐ Discuss the relationship between the Federal Reserve and commercial banks and thrifts.
- ☐ List and explain the seven major functions of the Federal Reserve System and indicate which one is most important.
- ☐ Discuss the reason for the independence of the Federal Reserve.

- ☐ Describe the relative decline of banks and thrifts.
- ☐ Explain the effects of consolidation on banks and thrifts.
- ☐ Discuss how globalization has changed financial markets.
- ☐ Explain how electronic payments have transformed banking.
- ☐ Discuss the reasons that U.S. currency is widely used in other nations (Last Word).

## ■ CHAPTER OUTLINE

1. Money is whatever performs the three **basic functions of money**: It is a **medium of exchange** for buying and selling goods and services. It serves as a **unit of account** for measuring the monetary cost of goods and services. It is a **store of value** so people can transfer purchasing power from the present to the future. A key advantage of money, especially in its cash form, is that it is widely accepted and easy to use for transactions. Other assets, such as real estate, stocks, or bonds, must first be converted to money before they can be used to make purchases. Ease with which such assets can be converted to money without losing purchasing power is a measure of the **liquidity** of an asset.

2. Money is a stock of items rather than a flow such as income. Any item that is widely accepted as a medium of exchange can serve as money, and many types of such items have done so throughout history.

a. The narrowly defined money supply is called **M1** and has two principal components.

(1) One component is **currency**: It consists of coins that are **token money**, which means the value of the metal in the coin is less than the face value of the coin. It also consists of paper money in the form of **Federal Reserve Notes**.

(2) The second component is **checkable deposits**. They allow a person to transfer ownership of deposits to others by the writing of checks; these checks are generally accepted as a medium of exchange.

(3) The two major types of financial institutions offering checkable deposits are **commercial banks** and **thrift institutions**.

(4) There also is currency and checkable deposits owned by the Federal government, commercial banks and thrift institutions, and the Federal Reserve Banks. They are excluded from the calculation of **M1** or in the other definitions of the money supply.

b. **M2** is a broader definition of money and includes not only the currency and checkable deposits in **M1** but also **near-monies** that do not function directly or fully as a medium of exchange, but which can be easily converted to currency or checkable deposits. **M2** includes

- (1) **M1** (currency and checkable deposits); plus
- (2) savings deposits, which include money in **savings accounts** and also **money market deposit accounts (MMDAs)**, interest-bearing accounts with short-term securities; plus

(3) **small time deposits** of less than \$100,000, such as "certificates of deposit" (CDs); plus

(4) **money market mutual funds (MMMFs)** held by individuals.

3. The **money supply gets its "backing"** from the ability of the government to keep the purchasing power of money stable.

a. Money is debt or the promise of a commercial bank, a thrift institution, or a Federal Reserve Bank to pay, but these debts cannot be redeemed for anything tangible.

b. Money has value only because:

(1) It is acceptable for the exchange of desirable goods and services.

(2) It is **legal tender** (legally acceptable for payment of debts).

(3) It is relatively scarce because its value depends on supply and demand conditions.

c. The purchasing power of money is the amount of goods and services a unit of money will buy.

(1) The purchasing power of the U.S. dollar is inversely related to the price level: Value of the dollar ( $\$V$ ) = 1 divided by price level ( $P$ ) expressed as an index number (in hundredths), or  $\$V = 1/P$ .

(2) Rapid inflation can erode the purchasing power of money and public confidence in it. Such situations limit the functions of money as a medium of exchange, measure of value, or store of value.

d. Money is backed by the confidence the public has that the purchasing power of money will remain stable. U.S. monetary authorities (the Federal Reserve) are responsible for using monetary policy to maintain price-level stability and the purchasing power of money. The actions of the U.S. government are also important because sound fiscal policy supports price-level stability.

4. The monetary and financial sector of the economy is significantly influenced by the **Federal Reserve System (the Fed)** and the nation's banks and thrift institutions.

a. The banking system remains centralized and regulated by government because historical problems in the U.S. economy led to different kinds of money and the mismanagement of the money supply. The U.S. Congress passed the Federal Reserve Act of 1913 to establish the Fed as the nation's central bank to be responsible for issuing currency and controlling the nation's money supply.

b. The **Board of Governors** of the Fed exercises control over the supply of money and the banking system. The U.S. president appoints the seven members of the Board of Governors, who serve for 14 years. The president also selects the board chair and vice chair, who serve 4-year terms.

c. The 12 **Federal Reserve Banks** of the Fed have three main functions.

(1) They serve as the nation's **central bank** to implement the policies set by the Board of Governors.

(2) They are **quasi-public banks** that blend private ownership of each Federal Reserve Bank with public control of each bank through the Board of Governors.

(3) They are “*bankers’ banks*” that perform banking services for the member banks in their regions.

d. The **Federal Open Market Committee (FOMC)** is responsible for acting on the monetary policy set by the Board of Governors. The FOMC includes the seven members of the Board of Governors, the president of the New York Federal Reserve Bank, plus 4 other presidents of Federal Reserve banks (who serve on a rotating basis). The FOMC conducts open market operations to buy and sell government securities to control the nation’s money supply and influence interest rates.

e. The U.S. banking system contains about 7,300 commercial banks. About three-fourths of these are banks chartered by states and about one-fourth of these are banks chartered by the Federal government. The banking system also includes about 11,000 thrift institutions, such as savings and loans and credit unions. Both banks and thrifts are directly affected by the Fed’s decisions concerning the money supply and interest rates.

f. The Fed performs seven functions: issuing currency, setting reserve requirements and holding reserves, lending money to banks and thrifts, collecting and processing checks, serving as the fiscal agent for the Federal government, supervising banks, and controlling the money supply. The last function is the most important.

g. The Federal Reserve is an independent agency of government with control of the money supply and influence over interest rates. This independence helps insulate it from political pressure from the U.S. Congress or the U.S. president when the Fed decides to adopt a necessary, but possibly unpopular, monetary policy such as raising interest rates to combat inflation.

5. Recent developments have affected money and banking in the U.S. economy.

a. The U.S. **financial services industry** consists not only of banks and thrifts, but also of insurance companies, mutual fund companies, pension funds, and securities firms. Over the past 25 years, the amount of financial assets managed by banks and thrifts fell from nearly 60 percent to about 24 percent as households shifted financial assets to these other types of financial services firms.

b. The number of banks and thrift institutions has declined, partly as a result of bank and thrift mergers. These mergers enable banks and thrifts to compete more effectively within the financial services industry on a national or regional basis.

c. There has also been a convergence and growing similarity in the types of financial services offered by different financial institutions such as banks, thrifts, insurance companies, mutual funds, pension funds, and securities firms.

d. Financial markets are now more integrated and operate worldwide because of advances in communications technologies and greater competition for financial capital assets around the globe.

e. The character of money has changed with the shift to the widespread use of **electronic payments** to make purchases and settle debts and greater use of electronic forms of money.

6. A large amount of U.S. currency is circulating abroad for use by residents of other nations. The “global green-back” is demanded because the dollar does a better job of holding its purchasing power relative to domestic currencies, especially in those nations that have experienced high inflation, wars, and political turmoil. The dollar in these nations serves an effective and reliable medium of exchange, store of value, and unit of account compared with domestic currencies.

#### ■ HINTS AND TIPS

1. The value of money is largely based on trust or acceptability. You are willing to accept money in exchange for a good or service because you are confident you will be able to use that money to purchase other goods and services or store its value for later use. If you lose trust in money, then it no longer functions as a medium of exchange, store of value, or measure of value for you and probably many other people.

2. Most students typically think of money as only currency: coins and paper money in circulation. A key component of the money supply, however, is the checkable deposits held at banks and thrift institutions on which checks can be drawn.

3. There are two definitions of the **money supply** that you must know about, from the narrow **M1** to the broader **M2**. The essential relationship among them is that currency and checkable deposits are the main parts of each one.

4. A good portion of the chapter explains the framework of the Federal Reserve. The institutional features are important for understanding how the nation’s central bank works, and the Fed will be a major focus of later chapters.

#### ■ IMPORTANT TERMS

liquidity

medium of exchange

unit of account

store of value

**M1**

token money

Federal Reserve  
Notes

checkable deposits

commercial banks

thrift institutions

near-monies

**M2**

savings account

money market  
deposit account  
(MMDA)

time deposits

money market mutual  
fund (MMMF)

legal tender

Federal Reserve  
System

Board of Governors

Federal Reserve  
Banks

Federal Open Market  
Committee (FOMC)

financial services  
industry

electronic payments

## SELF-TEST

### ■ FILL-IN QUESTIONS

1. When money is usable for buying and selling goods and services, it functions as (a unit of account, a store of value, a medium of exchange) \_\_\_\_\_, but when money serves as a measure of relative worth, it functions as \_\_\_\_\_, and when money serves as a liquid asset it functions as \_\_\_\_\_.
2. The ease with which an asset can be converted into money such as cash with little or no loss in purchasing power is its (credit, liquidity) \_\_\_\_\_. Assets that can be converted into cash more easily than other assets are (more, less) \_\_\_\_\_ liquid assets.
3. All coins in circulation in the United States are (paper, token) \_\_\_\_\_ money, which means that their intrinsic value is (less, greater) \_\_\_\_\_ than the face value of the coin.
4. Paper money and coins are considered (currency, checkable deposits) \_\_\_\_\_ and are one major component of **M1**; the other major component is (currency, checkable deposits) \_\_\_\_\_.
5. **M2** is equal to **M1** plus (checking, savings) \_\_\_\_\_ deposits that include money market (deposit accounts, mutual funds) \_\_\_\_\_, plus (small, large) \_\_\_\_\_ time deposits, and plus money market (deposit accounts, mutual funds) \_\_\_\_\_.
6. Credit cards (are, are not) \_\_\_\_\_ considered money but rather a form of (paper money, loan) \_\_\_\_\_ from the institution that issued the card.
7. Paper money is the circulating debt of (banks and thrifts, the Federal Reserve Banks) \_\_\_\_\_, while checkable deposits are the debts of \_\_\_\_\_. In the United States, currency and checkable deposits (are, are not) \_\_\_\_\_ backed by gold and silver.
8. Money has value because it is (unacceptable, acceptable) \_\_\_\_\_ in exchange for products and resources, because it is (legal, illegal) \_\_\_\_\_ tender, and because it is relatively (abundant, scarce) \_\_\_\_\_.
9. The purchasing power of money varies (directly, inversely) \_\_\_\_\_ with the price level. To find the value of \$1 (multiply, divide) \_\_\_\_\_ 1 by the price level.
10. Runaway inflation may significantly (increase, decrease) \_\_\_\_\_ the purchasing power of money and \_\_\_\_\_ its acceptance as a medium of exchange.
11. Government's responsibility in stabilizing the purchasing power of money calls for effective control over the (demand for, supply of) \_\_\_\_\_ money and the application by the president and Congress of appropriate (monetary, fiscal) \_\_\_\_\_ policies.
12. The Federal Reserve System is composed of the Board of (Banks, Governors) \_\_\_\_\_ and the 12 Federal Reserve \_\_\_\_\_. These policies of the Federal Reserve are often carried out by the (Federal Deposit Insurance Corporation, Federal Open Market Committee) \_\_\_\_\_.
13. The Federal Reserve Banks are (private, quasi-public) \_\_\_\_\_ banks, serve as (consumers', bankers') \_\_\_\_\_ banks, and are (local, central) \_\_\_\_\_ banks whose policies are coordinated by the Board of Governors.
14. The Federal Open Market Committee meets regularly to buy and sell government (currency, securities) \_\_\_\_\_ to control the nation's money supply and influence (productivity, interest rates) \_\_\_\_\_.
15. The U.S. banking system is composed of about 7300 (thrifts, commercial banks) \_\_\_\_\_ and about 11,000 \_\_\_\_\_.
16. The seven major functions of the Fed are
  - a. \_\_\_\_\_
  - b. \_\_\_\_\_
  - c. \_\_\_\_\_
  - d. \_\_\_\_\_
  - e. \_\_\_\_\_
  - f. \_\_\_\_\_
  - g. \_\_\_\_\_
 Of these, the most important function is \_\_\_\_\_.
17. The Congress established the Fed as a(n) (dependent, independent) \_\_\_\_\_ agency of government. The objective was to protect it from political pressure so it could control (taxes, inflation) \_\_\_\_\_.
18. In the past decade, the number of banks and thrifts (increased, decreased) \_\_\_\_\_ because competition from other financial institutions has

\_\_\_\_\_ and also mainly because of (mergers, bankruptcies) \_\_\_\_\_ among banks and thrift institutions.

19. Two other recent developments in money and banking are the (convergence, globalization) \_\_\_\_\_ of services provided by U.S. financial institutions and the \_\_\_\_\_ of financial markets.

20. Households and businesses are also increasingly using (paper, electronic) \_\_\_\_\_ payments for transactions such as credit cards, debit cards, Fedwire transfers, and automated clearinghouse transactions (ACH). New forms of electronic money may include (credit, smart) \_\_\_\_\_ cards and (stored-value, transfer-value) \_\_\_\_\_ cards.

### ■ TRUE-FALSE QUESTIONS

Circle T if the statement is true, F if it is false.

1. When the price of a product is stated in terms of dollars and cents, then money is functioning as a unit of account. T F

2. Real estate would be an example of a highly liquid asset. T F

3. The money supply designated M1 is the sum of currency and savings deposits. T F

4. The currency component of M1 includes both coins and paper money. T F

5. If a coin is token money, its face value is less than its intrinsic value. T F

6. Both commercial banks and thrift institutions accept checkable deposits. T F

7. The checkable deposits of the Federal government at the Federal Reserve Banks are a component of M1. T F

8. M2 exceeds M1 by the amount of savings deposits (including money market deposit accounts), small time deposits, and the money market mutual funds of individuals. T F

9. A small time deposit is one that is less than \$100,000. T F

10. The money supply in the United States essentially is "backed" by the government's ability to keep the value of money relatively stable. T F

11. The major components of the money supply are debts, or promises to pay. T F

12. Currency and checkable deposits are money because they are acceptable to sellers in exchange for goods and services. T F

13. If money is to have a fairly stable value, its supply must be limited relative to the demand for it. T F

14. The amount a dollar will buy varies directly with the price level. T F

15. Price-level stability requires effective management and regulation of the nation's money supply. T F

16. Members of the Board of Governors of the Federal Reserve System are appointed by the president of the United States and confirmed by the Senate. T F

17. The Federal Reserve Banks are owned and operated by the U.S. government. T F

18. Federal Reserve Banks are bankers' banks because they make loans to and accept deposits from depository institutions. T F

19. The Federal Open Market Committee (FOMC) is responsible for keeping the stock market open and regulated. T F

20. The Federal Reserve Banks are responsible for issuing currency. T F

21. At times, the Fed lends money to banks and thrifts, charging them an interest rate called the bank and thrift rate. T F

22. The Federal Reserve acts as the fiscal agent for the Federal government. T F

23. Congress established the Fed as an independent agency to protect it from political pressure so that it can effectively control the money supply and maintain price stability. T F

24. In recent years, banks and thrifts have increased their share of the financial services industry and control of financial assets. T F

25. Households and businesses are increasingly using electronic payments to buy and sell goods and services. T F

### ■ MULTIPLE-CHOICE QUESTIONS

Circle the letter that corresponds to the best answer.

1. Which one is an economic function of money?  
(a) a store of gold  
(b) a unit of account  
(c) a factor of production  
(d) a medium of communications

2. Each month Marti puts a certain percentage of her income in a bank account that she plans to use in the future to purchase a car. For Marti, the money saved in the bank account is primarily functioning as  
(a) legal tender  
(b) token money  
(c) store of value  
(d) medium of exchange

3. Which one of the following items would be considered to be perfectly liquid from an economic perspective?  
(a) cash  
(b) stocks

- (c) real estate
  - (d) certificate of deposits
4. Which one of the following is included in *currency* component of **M1**?
- (a) gold certificates
  - (b) silver certificates
  - (c) checkable deposits
  - (d) Federal Reserve Notes
5. Checkable deposits are money because they are
- (a) legal tender
  - (b) fiat money
  - (c) token money
  - (d) a medium of exchange
6. What type of financial institution accepts deposits from and lends to "members," who are usually a group of people who work for the same company?
- (a) credit unions
  - (b) commercial banks
  - (c) mutual savings banks
  - (d) savings and loan associations
7. Which of the following would be excluded from **M1** and other measures of the money supply?
- (a) coins held by the public
  - (b) currency held by banks
  - (c) Federal Reserve Notes held by the public
  - (d) checkable deposits of individuals at commercial banks
8. Which constitutes the largest element in the **M2** money supply?
- (a) savings deposits
  - (b) small time deposits
  - (c) checkable deposits
  - (d) money market mutual funds held by individuals

Use the following table to answer Questions 9 and 10 about the money supply, given the following hypothetical data for the economy.

Item	Billions of dollars
Savings deposits, including MMDAs	\$3452
Small time deposits	997
Currency	721
Checkable deposits	604
Money market mutual funds of individuals	703
Money market mutual funds of businesses	1153

9. The size of the **M1** money supply is
- (a) \$1307
  - (b) \$1325
  - (c) \$1719
  - (d) \$1856
10. The size of the **M2** money supply is
- (a) \$4777
  - (b) \$5774
  - (c) \$6477
  - (d) \$7630
11. Are credit cards considered to be money?
- (a) Yes, because their value is included in the calculation of **M1**.
  - (b) Yes, because their value is included in the calculation of **M2**.
  - (c) No, because they provide a short-term loan to cardholders from a financial institution that issued the card.
  - (d) No, because the card transactions are not insured either by the Federal Reserve banks or the U.S. Treasury.
12. The major components of the money supply—paper money and checkable deposits—are
- (a) legal tender
  - (b) token money
  - (c) debts, or promises to pay
  - (d) assets of the Federal Reserve Banks
13. Which *best* describes the backing of money in the United States?
- (a) the gold bullion that is stored in Fort Knox, Kentucky
  - (b) the belief of holders of money that it can be exchanged for desirable goods and services
  - (c) the willingness of banks and the government to surrender something of value in exchange for money
  - (d) the confidence of the public in the ability of government to pay off the national debt
14. If the price level increases 20%, the purchasing power of money decreases
- (a) 14.14%
  - (b) 16.67%
  - (c) 20%
  - (d) 25%
15. High rates of inflation in an economy will
- (a) increase the purchasing power of money
  - (b) decrease the conversion of money to gold
  - (c) increase the use of money as a measure of value
  - (d) decrease the use of money as a medium of exchange
16. To keep the purchasing power of money fairly stable, the Federal Reserve
- (a) buys corporate stock
  - (b) employs fiscal policy
  - (c) controls the money supply
  - (d) uses price and wage controls
17. The members of the Board of Governors of the Federal Reserve System are appointed by
- (a) member banks of the Federal Reserve System
  - (b) members of the Federal Open Market Committee
  - (c) the U.S. president and confirmed by the Senate
  - (d) the presidents of the 12 Federal Reserve Banks
18. The Board of Governors and 12 Federal Reserve Banks as a system serve as
- (a) a central bank
  - (b) a regulator of the stock market

- (c) the printer of U.S. paper money  
(d) the issuer of the nation's gold certificates
19. The 12 Federal Reserve Banks are  
(a) publicly owned and controlled  
(b) privately owned and controlled  
(c) privately owned, but publicly controlled  
(d) publicly owned, but privately controlled
20. The Federal Reserve Banks perform essentially the same functions for  
(a) the public as do commercial banks and thrifts  
(b) Federal government as does the U.S. Treasury  
(c) commercial banks and thrifts as those institutions do for the public  
(d) commercial banks and thrifts as does the Federal Deposit Insurance Corporation
21. The Federal Open Market Committee (FOMC) of the Federal Reserve System is primarily responsible for  
(a) supervising the operation of banks to make sure they follow regulations and monitoring banks so they do not engage in fraud  
(b) handling the Fed's collection of checks and adjusting legal reserves among banks  
(c) setting the Fed's monetary policy and directing the buying and selling of government securities  
(d) acting as the fiscal agent for the Federal government and issuing currency
22. The Federal Reserve is responsible for  
(a) supervising all banks and thrifts  
(b) printing currency for banks and thrifts  
(c) collecting Federal taxes from banks and thrifts  
(d) holding the required reserves of banks and thrifts
23. The most important function of the Federal Reserve is  
(a) issuing currency  
(b) controlling the money supply  
(c) supervising banks and thrifts  
(d) lending money to banks and thrifts
24. Which one of the following is a recent development in the financial services industry?  
(a) an increase in the number of banks and thrifts  
(b) increased integration of world financial markets  
(c) increased use of coins and currency as a medium of exchange  
(d) an increase in the separation of services offered by financial institutions
25. Which one of the following would be a recent development in money and banking?  
(a) less reliance on global markets by financial institutions  
(b) less convergence in the types of services offered by financial institutions  
(c) greater use of electronic payments by financial institutions  
(d) a larger percentage of financial assets held by banks and thrifts compared to other financial institutions

## ■ PROBLEMS

1. From the figures in the following table it can be concluded that

Item	Billions of dollars
Small time deposits	\$1014
MMMFs held by individuals	743
Checkable deposits	622
Savings deposits, including MMDAs	3649
Currency	730
MMMFs held by businesses	1190

a. M1 is equal to the sum of \$ \_\_\_\_\_ and \$ \_\_\_\_\_, so it totals \$ \_\_\_\_\_ billion.

b. M2 is equal to M1 plus \$ \_\_\_\_\_ and \$ \_\_\_\_\_ and \$ \_\_\_\_\_, so it totals \$ \_\_\_\_\_ billion.

2. Complete the following table that shows the relationship between a percentage change in the price level and the percentage change in the purchasing power of money. Calculate the percentage change in the purchasing power of money to one decimal place.

Change in price level	Change in purchasing power of money
a. rises by:	
5%	— %
10%	—
15%	—
20%	—
25%	—
b. falls by:	
5%	+ _____
10%	+ _____
15%	+ _____

## ■ SHORT ANSWER AND ESSAY QUESTIONS

- How would you define money based on its three functions?
- What is the definition of liquidity as it relates to money? Give examples of liquid and illiquid assets.
- What are the two components of the M1 supply of money in the United States?
- Why are coins token money?
- What are checkable deposits?
- Describe the different types of institutions that offer checkable deposits.

7. Are the checkable deposits of government, the Fed, commercial banks, and other financial institutions included in M1? Explain.

8. Define M2 and explain why it is used.

9. What is the purpose of having two definitions of the money supply? What is the relationship between the two definitions?

10. What backs the money used in the United States? What determines the purchasing power of money?

11. Explain the relationship between the purchasing power of money and the price level.

12. What must government do if it is to stabilize the purchasing power of money?

13. Describe the purpose and membership of the Board of Governors of the Federal Reserve System.

14. Explain the three major characteristics of the Federal Reserve Banks.

15. What is the Federal Open Market Committee and how does it operate?

16. Describe the differences in commercial banks and thrifts in terms of numbers, purpose, and regulation agencies.

17. What are the seven major functions of the Fed and which function is most important?

18. What are the basic reasons for the independence of the Federal Reserve System?

19. Describe the decline of and consolidation among banks and thrifts in recent years.

20. Discuss the meaning and effects of increased integration of world financial markets.

13. quasi-public, bankers', central

14. securities, interest rates

15. commercial banks, thrifts

16. a. issuing currency; b. setting reserve requirements and holding reserves; c. lending money to banks and thrifts; d. collecting and processing checks; e. serving as fiscal agent for the Federal government; f. bank supervision; g. controlling the money supply; controlling the money supply

17. independent, inflation

18. decreased, increased, mergers

19. convergence, globalization

20. electronic, smart, and stored-value

### TRUE-FALSE QUESTIONS

- |                   |                    |               |
|-------------------|--------------------|---------------|
| 1. T, p. 630      | 10. T, p. 634      | 19. F, p. 638 |
| 2. F, p. 630      | 11. T, p. 634      | 20. T, p. 638 |
| 3. F, p. 631      | 12. T, p. 634      | 21. F, p. 638 |
| 4. T, p. 631      | 13. T, p. 634      | 22. T, p. 639 |
| 5. F, p. 631      | 14. F, pp. 634–635 | 23. T, p. 639 |
| 6. T, p. 632      | 15. T, p. 635      | 24. F, p. 639 |
| 7. F, p. 632      | 16. T, p. 636      | 25. T, p. 641 |
| 8. T, pp. 633–634 | 17. F, pp. 636–637 |               |
| 9. T, pp. 633–634 | 18. T, p. 637      |               |

### MULTIPLE-CHOICE QUESTIONS

- |                   |                    |                    |
|-------------------|--------------------|--------------------|
| 1. b, p. 630      | 10. c, pp. 632–633 | 19. c, p. 637      |
| 2. c, p. 630      | 11. c, p. 633      | 20. c, p. 637      |
| 3. a, p. 630      | 12. c, pp. 633–634 | 21. c, p. 638      |
| 4. d, p. 631      | 13. b, p. 634      | 22. d, p. 638      |
| 5. d, pp. 631–632 | 14. b, pp. 634–635 | 23. b, p. 639      |
| 6. a, p. 632      | 15. d, p. 635      | 24. b, pp. 640–641 |
| 7. b, p. 632      | 16. c, p. 635      | 25. c, p. 641      |
| 8. a, pp. 632–633 | 17. c, p. 636      |                    |
| 9. b, p. 632      | 18. a, p. 636      |                    |

## ANSWERS

### Chapter 31 Money and Banking

#### FILL-IN QUESTIONS

- a medium of exchange, a unit of account, a store of value
- liquidity, more
- token, less
- currency, checkable deposits
- savings, deposit account, small, mutual funds
- are not, loan
- the Federal Reserve Banks, banks and thrifts, are not
- acceptable, legal, scarce
- inversely, divide
- decrease, decrease
- supply of, fiscal
- Governors, Banks, Federal Open Market Committee

#### PROBLEMS

- a. 730, 622 (either order), 1,352; b. 3649, 1014, 743 (any order), 6758
- a. 4.8, 9.1, 13, 16.7, 20; b. 5.3, 11.1, 17.6

#### SHORT ANSWER AND ESSAY QUESTIONS

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|----------------|-----------------|-----------------|
| 1. p. 630      | 8. pp. 632–633  | 15. p. 638      |
| 2. p. 630      | 9. pp. 632–633  | 16. p. 638      |
| 3. p. 631      | 10. pp. 633–634 | 17. pp. 638–639 |
| 4. p. 631      | 11. pp. 634–635 | 18. p. 639      |
| 5. pp. 631–632 | 12. p. 635      | 19. pp. 639–640 |
| 6. p. 632      | 13. p. 636      | 20. pp. 640–641 |
| 7. p. 632      | 14. pp. 636–637 |                 |